MR. MacGREGOR: Good morning. First I'd like to thank the members of the Trade Deficit Review Commission for this opportunity to brief you on the role of transfer pricing in international trade. I will discuss inter-company transactions for multinational corporations in an effort to bring to your attention issues that may deserve to be considered in your investigation of the U.S. trade deficit.

I'd like to begin by illustrating how transfer pricing works through an example. Imagine that you have a company that designs, makes, and markets a well-known line of watches. Let's say that that company is based here in Dallas. Let's also say that the company owns a manufacturing facility in Mexico and that it sells some of its watches in Canada through its subsidiary in that country.

The first question that we ask in transfer pricing is in what country does the company pay taxes for the watches sold in Canada. The answer to that question is easy, in all three countries. The second and more difficult question is how much should the company pay in taxes in each country? Indirectly we are asking how much profit should each company earn in each country, because taxes are levied on profits, and answering this question correctly will effect not only the profit performance of each of the company subsidiaries but more to our point today, the accuracy of the figures used to measure the trade balance.

I will not rehash the technical details involved in complying with transfer pricing regulations or the methods and principles used to establish correct pricing since I have already submitted a summary with that information in my written statement, but I would like to spend a minute talking about the way in which payments flow in an inter-company transaction.

To determine how much profit the watch company would earn in each country, we assign a sale price to each of the companies' subsidiaries in the U.S., Mexico, and Canada, so we would first look at the manufacturing facility in Mexico to estimate the level of profits that that entity should earn based on the profits earned by independent manufacturing facilities operating under similar circumstances.

Then we look at the selling and distribution company in Canada and we assign profits to that subsidiary in a similar fashion, by looking at independent distributors in Canada and determining what their profits are. We also need to look at other inter-company transactions involved in this sale.

For example, the company's management in Dallas probably lends management services to the manufacturing facility in Mexico, and the U.S. is usually compensated for these services; that is the U.S. company is compensated for these services. But the most complicated issue that arises in these transactions is the transfer of intangible assets.

In our example in my written statement, there is an intangible asset imbedded into the watch. In other words, the watch has a brand name and that brand name or trademark is the property of the U.S. parent company. Since a significant portion of the profits that are realized in the sale of this watch are attributable to the brand name, because without a brand the retail price of the watch would be much lower, then there should be a royalty payment made to the U.S. that is commensurate with the income derived from the brand name.

The purpose of this example is to show that for a multinational corporation, the sale of a product which may at first blush seem like a simple export in fact involves an intricate combination of both inbound and outbound transactions, and that the distribution of money to the companies in three countries is not an easy exercise, especially when intangible assets are involved.

The issue of inter-company transactions that involve intangible assets presents a real challenge to multinational companies and for tax authorities. Most products have some type of intangible asset, and in some cases, these assets are very valuable. Some intangible assets like trademark are more tangible, if I may say it that way, than others, because we can see them on the product. The swoosh on Nike shoes is a good example.

But there are many other types of intangibles, like know-how, design, licenses, contracts, technical data, or customer lists, to name only a few, that are much more difficult to isolate or to define precisely in a business transaction. In fact, in most cases such as in the watch example, instead of a single intangible, like a trademark, there are really a bundle of intangibles that together add substantial value to the product.

And while we might not be able to say exactly how much of the profits of the watch are attributable to the brand name versus the know-how or the design, we know, nonetheless, that this bundle of intangibles adds value to the product because we see higher than normal profits in that product.

So why does transfer pricing matter in the understanding of the U.S. trade deficit? The answer is that incorrect transfer pricing by companies may create a reporting error in a company's sales figures because the real market value of a product or service may be misstated. When exports and imports are counted, it is important to remember that for a multinational company a substantial portion of its purchases and sales may be performed with related parties, and in these transactions, there can be a significant discrepancy between the actual amount paid and the true market value of the product or service if the company does not price these transactions correctly.

While there are fairly detailed methodologies described in the transfer pricing regulations to determine transfer prices, in practice this is still a complicated subject and many companies still rely on simple and often arbitrary calculations to establish in their company prices due to a lack of expertise and limited resources.

The presence of intangible assets complicates matters further when sales of a product are made to unrelated parties in other countries. Then the value of their intangible assets, if they are present, is either already accounted for in the price of the product or through a royalty payment, so they don't create a problem when we make sales to unrelated parties.

But when the intangible assets in question are in a product that is sold between related parties, as is the case in our example, when the U.S. sells the watch to its Canadian subsidiary, then the true value of the sale may be underreported if the subsidiary in the foreign country is either paying for the product at its marginal cost or if it pays a royalty that does not entirely compensate the U.S. parent for the value of its licensing rights.

This is an issue that will increase in significance as technology continues to play a greater role in the mix of products that make up U.S. exports, and as U.S. products are loaded with more intangible assets, measuring their value with the methods currently available will become increasingly difficult.

I'd like to conclude by saying that in order to ensure that the measurements of U.S. trade balance figures accurately reflect the value of transactions that they intend to quantify, it is important to take into account the possible error that may be introduced into the equation due to inter-company transactions. Furthermore, the increased presence of intangible assets in these transactions has created a need to develop transfer-pricing methods that give multinational corporations the ability to properly report the value of those transactions.

Thank you.